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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

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Recent International Monetary Trends

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1971

INTELLIGENCE MEMORANDUM

RECENT INTERNATIONAL MONETARY TRENDS

Conclusions

1. There has been a continuing and probably accelerating erosion of European confidence in the stability of the US dollar throughout 1971. The situation worsened between May and late July when disquieting reports concerning the US economy began to accumulate. Inflation was proving difficult to contain, wage settlements were extremely high in the European view, but most importantly the US balance-of-payments deficit was clearly worsening and the prospect was that the flow of unwanted dollars to Europe would accelerate.

2. It is probable that Europe may either impose new or strengthen existing controls on US long-term capital flows. Restrictions on exports to the United States or controls on US tourist spending are unlikely, the latter, because of the domestic furor in Europe that would result.

3. In any event, as the US balance of payments continues to deteriorate we can expect continued talk of dollar devaluation, gyrations in the price of gold, and speculative runs into one currency or another. Despite the fact that no industrial power would want to precipitate a breakdown in the international monetary system, the continued loss of US international reserves could precipitate actions that would have the same effect.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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Introduction

4. This summer new and fundamental difficulties have beset the dollar and European concern over its continuing weakness has intensified. After the May 1971 upheaval the Europeans became particularly disturbed by the fact that the FY 1971 budget deficit was unexpectedly large and that the US balance of payments – including the basic balance – deteriorated during the second quarter of 1971. More recently, large wage and price increases have taken place, the US balance of trade has worsened, and US gold reserves have declined to a new low. In response, the German mark, contrary to earlier Bundesbank intentions, has appreciated by nearly 6% since 9 May, substantial sums of dollars have been accumulated by a number of central banks, notably those of France and Japan – indeed, France has been the target of a new dollar flow – and the free-market price of gold has moved steadily upward.

5. This memorandum describes the reactions and attitudes of Europeans, Canadians, and Japanese to recent monetary developments.

Discussion

Background 1/

6. From the beginning of 1970 into early 1971 US interest rates fell sharply as monetary policy was eased to stimulate economic recovery. At the same time, however, the West German central bank, the Bundesbank, followed a policy of monetary stringency, which kept short-term interest rates high. The resulting spread in US - West German interest rates – about 3.5 percentage points by the end of March 1971 – and the sharp rise in the Eurodollar rates at the same time prompted a massive flow of short-term capital into strong European currencies, particularly the mark.

7. In the 15 months ending March 1971, the Bundesbank's foreign exchange holdings expanded by nearly $8 billion. Because the Bundesbank paid for these dollars with marks, the reserves of the commercial banking system expanded, fostering in turn an increase in the domestic money supply; West Germany's money supply grew 22.5% from March 1970 to March 1971. It thus became increasingly apparent that the West German authorities would be forced to act.

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8. Speculation, which added to the interest-motivated dollar inflow in late April, reached a fever pitch in early May. On 3 and 4 May alone, about $1 billion flowed into the Bundesbank. On Wednesday morning, 5 May, speculators – expecting an imminent mark revaluation – converted about $1 billion into marks in less than one hour. West German authorities then closed the foreign exchange market and the Bundesbank withdrew its support for the dollar. Shortly thereafter, the central banks of the Netherlands, Belgium, Switzerland, and Austria also suspended trading. On the following Monday, 10 May, the West German foreign exchange markets resumed trading with the German mark "floating"; that is, the authorities allowed the mark to rise more than 1% above its official parity of 3.66 marks per US dollar. The Dutch guilder was also floating, as was the Belgian franc with respect to capital transactions, while the Swiss franc and Austrian schilling had been revalued upward by 7.1% and 5.05%, respectively.

Monetary Developments Since 9 May 1971

9. Because the immediate cause of the monetary turmoil this past spring apparently arose from transitory conditions, many either believed or hoped that the resulting international exchange rate dislocations would be temporary. Out-of-phase business cycles were seen as the principal contributor to the wide disparities between the high interest rate levels in West Germany and other European countries and the lower rates of the United States. Other factors included the practice of certain European central banks of placing some of their reserves directly in the Eurodollar market, which subsequently returned to their coffers to be again counted, and repayment of most of the Eurodollar borrowings by the home offices of US commercial banks to their European branches.

10. There was, therefore, doubt as to whether fundamental imbalances requiring parity adjustments among the currencies existed. The resolution adopted on 9 May by the Council of the European Communities authorizing the actions taken by Bonn, Brussels, and The Hague emphasized that although floating rates may have been warranted to curb excessive inflows of foreign capital no official change in parities was justified or contemplated.

11. Although the weakness of the dollar has been largely due to the persistent US balance-of-payments deficit, the attack on the dollar was seen by some last spring as being due to temporary factors. The current pressures now, however, spring from more fundamental causes. Moreover, tensions that were once localized in financial circles have become widespread during the summer. In July a report by the highly respected Morgan Guaranty Trust ended two relatively calm months on the exchange markets, from early May through early July, when it estimated the second quarter US balance-of-payments deficit as being $7 billion on the official settlements

basis, substantially greater than the $5.4 billion first quarter deficit; but, even more disturbing, the vitally important basic balance (current account and long-term capital transactions) also deteriorated, including a worsening of the trade balance. Pressure on the dollar then renewed and escalated in early August. Moreover, the reverberations have been felt in financial markets outside of West Germany, most notably in Japan, France, and the gold markets.

The European Community

12. When the German exchange markets opened on 10 May, the mark sold at nearly 4% above its parity. Initially, Bonn told its Common Market partners that it would try eventually to float the mark downwards to its original parity. However, when Finance Minister Karl Shiller also assumed the post of Economic Minister speculators saw the revaluation of the mark as increasingly likely. Despite a variety of pressures throughout the rest of May and until early July the Bundesbank was successful in holding the mark premium within the fairly narrow range of 3% to 4.5% above par, and at the same time selling off in June a net total of more than $2 billion in dollars.

13. There was little activity in the other European Community currencies during this period. The exchange rate movements of the floating Dutch guilder and the split-rate Belgian franc paralleled those of the mark but with much less volume and smaller premiums. The Italian lira and even the French franc remained essentially untouched.

14. The going became considerably rougher for the dollar in July, however. The Bundesbank had difficulty selling additional dollars at less than a 4.5% premium. At the same time, increasing money market rates in Germany relative to Eurodollar rates reduced the costs to speculators holding marks. The Bundesbank wishing to continue selling dollars lowered its dollar floor and allowed the mark to move to more than 5% above parity for the first time. The situation was further aggravated when some German officials publicly stated that the feasibility of ending the float and returning to the original parity had become remote.

15. The main activity in July, however, involved the French franc. Speculative short-term capital movements into France apparently was inspired by the discussions among the EC finance ministers at the beginning of the month concerning the proposed adoption by the IMF of wider margins within which more closely harmonized EC currencies could move against the dollar. This prospect suggested to speculators that if the mark was revalued the franc probably would be too. The Bank of France, intervening in the market, purchased more than $1 billion during July

despite a number of exchange controls. Disclosure of French plans in late July to buy $191 million in gold from the United States to repay a debt to the IMF came soon after the US Treasury Department made it known that the US gold reserves had already dropped to the lowest level since 1935. Accordingly, the already rapid flow of dollars into France was spurred.

16. On 4 August, the Bank of France imposed more rigorous controls, specifically prohibiting commercial banks from accepting additional foreign currency from abroad except for valid trade transactions. The initial confusion among exchange dealers as to the intent of this measure led to further dollar movements into other currencies and gold. The mark rose to a new high of 6% over parity. The financial markets were just beginning to recover from this disturbance when a 7 August press release of a US Congressional subcommittee's report that the dollar was overvalued gave the dollar its most severe battering since 5 May: on Monday, 9 August, the mark premium over its parity with the dollar rose to 7%.

Japan

17. Tokyo's tight exchange controls make it impossible for speculators to convert substantial amounts of short-term funds into yen. Many Japanese businessmen, however, believing revaluation imminent, began hedging this past spring by converting their current dollar receipts into yen.

18. Since early May, therefore, Japan has been the recipient of a continuing inflow of dollars – largely because of highly favorable current account balances. In May and June the inflow surpassed $1 billion per month. Although the dollar inflow subsided somewhat in July – Japan increased its dollar holdings by more than $600 million – the inflows expanded sharply to almost $400 million during the first week of August; typically, it should be noted, the first week of each month sees the largest gain in reserves. The increased dollar inflows, as expected, have touched off further rumors of a yen revaluation.

Other Major Currencies

19. Until August few other currencies were significantly affected by foreign exchange activities. Now nearly all currencies have strengthened against the dollar. The Bank of England acquired about $700 million during June and July, but this was mainly unrelated to any disturbances in the foreign exchange markets but rather to meet the needs of oil companies for oil royalties and tax payments. The position of the Canadian dollar changed little over the past three months, responding primarily to normal seasonal commercial factors. During June and July the Swiss National Bank

was able to sell $400 million -- of the $700 million of speculative funds that it absorbed during the week prior to its revaluation – while maintaining the franc rate below its new par value. In early August, however, the Swiss were heavily deluged by dollars as a result of the French action and the rumors of dollar devaluation. On 9 August, in order to reduce speculative inflows, the Swiss National Bank delayed for ten days all Swiss franc payments for dollars presented by exchange dealers for conversion.

Gold

20. The London free market price of gold spurted from $40.24 on 9 July an ounce to $43.94 on 9 August, the highest level since the two-tier market for gold was established in March 1968. The price rise in London and on the continent at first reflected the uncertainties in the foreign exchange markets at a time when the French franc was under pressure. Later increases were spurred by unsettling economic news from the United States.

Reasons for Current Turmoil

21. In recent weeks a stream of unfavorable news on the performance of the US economy has refocused European attention on the dollar. The revelation in late July that the US balance of trade was in deficit for the third month in a row -- placing the trade deficit for the first half of the year into the red as well – confirmed European suspicions that the US balance of payments is in fundamental disequilibrium and that drastic changes will be necessary to correct the continuing and rapidly growing payments deficit.

22. European fears about the strength of the dollar arise not only because of the large payments deficit, especially the fundamental deterioration on trade account. 2/ More importantly, many of them believe that the US economy is not being soundly managed. There is little belief in Europe that the battle against inflation is being won. They see the 31% wage increases in the telephone and steel industries over 3 years, and a 42% pay hike for railroad workers over 42 months, though anticipated last winter, as pointing the way to continuing increases in the cost of goods and services, thus damaging US export capabilities. Added to this is the FY 1971 $23.2 billion federal budget deficit, and a less than optimistic forecast by the OECD about the near-term performance of the US economy.

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2. On a balance-of-payments basis the US trade deficit for the first half of 1971 was more than $700 million. This contrasts to a $1.68 billion surplus for the same period in 1970.

23. Europeans, nervous about US economic prospects, see the performance of Wall Street as reinforcing their beliefs. The recent sharp drop in security prices reflects American uneasiness about economic prospects. On one hand, inflation is a continuing problem despite some moderation in the rate of price advances in early 1971, while on the other hand, unemployment remains uncomfortably high. All in all, Europeans seem to believe that faced with these domestic concerns, the US Government is willing to relegate the balance of payments to a lower priority than the task of reflating the economy.